SQUIRE PATTON BOGGS

US Treasury Proposes a New Definition of "Political Subdivision" for Tax-Exempt Bond Purposes

The proposed regulations purport to interpret and clarify current law, but countless municipal bond issuers could be caught in the crossfire.

In its zeal to curtail the use of tax-exempt financing by certain development districts, the IRS has proposed a new definition of "political subdivision" that could terminate the status of numerous governmental entities whose governing boards are appointed rather than elected, making them ineligible to issue tax-exempt debt or use tax-exempt financed facilities as a governmental user.

Potentially affected municipal issuers include **port and airport authorities, public hospital districts, public housing authorities, turnpike and expressway authorities and similar entities**. While these regulations remain in proposed form, issuers who might be caught up in the broad provisions of the regulations should consider voicing their concerns directly to the IRS. The public comment period for these proposed regulations ends at 11:59 p.m. EDT on May 23, 2016. The IRS has also scheduled a hearing for 10 a.m. EDT, June 6, 2016 at the IRS offices in Washington DC. If you want to speak at the hearing, you must make a request to do so by May 23, 2016.

Background (We Were Just Fine Until The Villages Audit Came Along)

Bond and tax lawyers have never had much angst over the requirements for an entity to qualify as a "political subdivision" for purposes of issuing tax-exempt bonds or using tax-exempt financed facilities as a governmental user. In fact, the political subdivision requirements stand out as one of the few areas of tax-exempt bond law that has gone basically unchanged through the years. A public entity that had the power to exercise a substantial amount of one of the three classic "sovereign powers" (taxation, eminent domain and the police (regulatory) power) was a political subdivision that was therefore eligible to issue tax-exempt bonds and to use tax-exempt financed facilities as a governmental user and not as a private person.

Then, in 2013, during the course of an audit of bonds issued by a community development district in Florida,[1] the IRS Office of Chief Counsel released a Technical Advice Memorandum (TAM 201334038), asserting that there were additional requirements for an entity to be considered a political subdivision for tax purposes and, not surprisingly, asserting that the district in the audit did not meet them. Specifically, the TAM looked at the existing language in the Treasury Regulations, which has been substantially the same since Treasury first promulgated regulations on this point in 1957: A political subdivision is "any division of any state or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit."

1 The Village Center Community Development District has publicly disclosed the nature of the ongoing audit, as well as the pertinent legal arguments put forth on both sides.

The TAM focused exclusively on the first clause – "any division of any state or local governmental unit" – and asserted that the clause imposed additional substantive requirements over and above the sovereign powers requirement, and concluded that, in general terms, because the issuer served private interests instead of public interests, it was not a division of a state or local governmental unit.

The TAM provoked resounding and widespread criticism from the public finance legal community, because it broke sharply with the established test for a political subdivision, making new law for all issuers in the context of an enforcement action against just a single issuer, which would result in far-reaching negative effects on outstanding tax-exempt bonds.

In 2015, the Chief Counsel's Office agreed that the 2013 TAM would have no retroactive effect. While this was welcomed by the public finance legal community, the prospective application of the new legal requirements set out in the TAM was still a cloud over certain segments of the public finance community. Several groups argued to the IRS that a change in the political subdivision rules for all issuers should be made only after notice and comment under the usual formal rulemaking process.

But, as proof of the adage "be careful what you wish for," the proposed regulations, issued on February 23, 2016, actually go **even further** than the 2013 TAM, and would make it more difficult for an entity to qualify as a political subdivision. The preamble to the proposed regulations claims that they "clarify and further develop" the test for political subdivision status. In fact, the proposed regulations cast aside a body of law whose principles ultimately reach back to the Woodrow Wilson administration. The proposed regulations could undermine the status of many governmental entities as political subdivisions, even though these governmental entities are not the types of special districts that have prompted the IRS's concern.

What Does It Take to be a Political Subdivision Under the New Proposed Regulations?

Under the proposed regulations, there would be two additional considerations on top of the existing sovereign powers requirement, which would come with the qualifier that the sovereign powers must be delegated by "a State or local law of general application."

The two new requirements are a **public purpose requirement** and a **governmental control requirement**.

Under the **public purpose requirement**, an entity must be organized for a public purpose and must continually operate for a public purpose. In addition, the entity must operate in a way that "provides a significant public benefit with **no more than incidental benefit to private persons**." (Emphasis added.) Treasury and the IRS presumably added this requirement to ensnare special districts and other entities that they believe are organized to benefit only private interests. Treasury officials have said publicly that the provision prohibiting more than incidental private benefits is intended to clarify the public purpose requirement, but it instead casts doubt on the continuing political subdivision status of governmental entities that might issue bonds for public purposes with private involvement, or that are engaged in other economic development activities. The public purpose requirement remains in place for the entire term of an entity's bonds. If at any time the IRS determines that the issuer is operating in a way that either does not provide a significant public benefit, or that provides more than an incidental benefit to any private party, then the status of all of the issuer's bonds will be in jeopardy.

The **governmental control requirement** requires that either a state or local government that meets certain requirements or a public electorate must "control" the entity. One entity controls another if it has a collection of ongoing rights and powers that enables it to direct significant actions of the other entity. The proposed regulations do not define these terms. Instead, the proposed regulations list three non-exclusive benchmarks of rights and powers that amount to control, if they can be taken on a discretionary, non-ministerial basis (in other words, "rubber-stamping" authority is not enough):

- The power **both** to approve and remove a majority of the entity's directors, and/or
- The power to elect a majority of the directors "in periodic elections," which is not defined, of "reasonable frequency," which is also not defined, and/or
- The power to approve or direct the significant uses of funds or assets of the entity in advance.

Other powers or rights may or may not be enough, based on the facts and circumstances. The proposed regulations also list several examples of actions that do not amount to control, including the right to dissolve the entity, or procedures designed to ensure the integrity of the entity, such as a requirement that the entity obey open meeting or conflict of interest laws.

In addition, either a state or local government meeting certain requirements or a public electorate must exercise "control," as defined above.

Control by a state or local government. One state or local government that has all three of the sovereign powers must control the entity, and it must exercise control by acting through its governing body or through its duly authorized elected or appointed officials. Importantly, entities that have governing boards appointed by multiple state or local governments do not appear to meet the control test unless a single governmental entity has the power to appoint/remove a majority of the governing board.

Control by a public electorate. If a state or local government meeting these requirements does not control the entity, then an electorate established under "a State or local law of general application," which is not a private faction, must control the entity. What is a private faction?

- A private faction **always** exists if any three private persons in the electorate have a majority of the votes necessary to determine the outcome.
- A private faction **never** exists if the smallest number of private persons who can combine their votes to get a majority is greater than 10 persons.
- In all other cases, a private faction exists where the outcome is decided solely by the votes of an "unreasonably small" number of private persons.

The proposed regulations provide that the meaning of "unreasonably small" will depend on the facts and circumstances, including the purpose of the entity, the number of members in the electorate, the relationships between members of the electorate to one another, the manner of apportionment of votes within the electorate and the extent to which the members of the electorate adequately represent the interests of persons reasonably affected by the entity's actions. (None of these terms is defined.)

To make things more complicated, in the above tests the proposed regulations treat related persons (including most family members) or members of a controlled group of corporations as though they all are the same person. In other words, the proposed regulations adopt the unusual position that family members all vote alike, ignoring the entire genre of Thanksgiving dinner-table humor.

Potential Traps

The governmental control requirements threaten the status of many entities that long have been acknowledged to be political subdivisions. Several potential traps exist:

- The controlling entity must have control rights on **an ongoing basis**. So, the ability of a government to create an entity and to approve the entity's organizational documents and plan of operation is not enough.
- Control must be left to the "discretion" of the controlling entity. That is, the ability to appoint board members or directors, but to remove them only "with cause," may not be enough.
- The power to appoint and remove directors must reside with the same entity. So, entities with governing boards appointed by one governmental entity, but who can only be removed by another do not appear to meet the control test.
- Similarly, entities that have governing boards appointed by multiple state or local governments also do not appear to meet the control test unless a single general purpose governmental entity has the power to appoint/remove a majority of the governing board. This jeopardizes the political subdivision status of entities that are formed under interlocal agreements, joint powers authorities, multistate compacts, or other arrangements where multiple governments control the entity.

- Smaller entities comprised of a few property owners (irrigation districts in rural areas, etc.) or very small towns with few registered voters may violate the private faction rules. Unless an entity falls within the "greater than 10 person majority" safe harbor, bond counsel may have a very difficult time reaching an unqualified bond counsel opinion standard on the entity's bonds.
- What are "periodic elections" of "reasonable frequency"? How would this affect entities whose directors serve lengthy terms?

There are literally thousands of governmental entities whose governing boards are appointed by one or more general governmental entities or officials (for example, a state governor or county commissions), but the power to remove a member of the board is limited to removal for cause and, perhaps, reserved only to the state governor. Potentially affected municipal issuers include port and airport authorities, public hospital districts, public housing authorities, turnpike, bridge and expressway authorities and similar entities. If Treasury adopts the proposed regulations in their current form, the status of these entities as political subdivisions will have to be analyzed anew. If one of these entities does not have control features that are sufficient to satisfy the benchmarks identified in the proposed regulations, the entity may need to seek formal guidance from the IRS as to its status for federal income tax purposes.

Also, the Preamble to the proposed regulations states that the proposed regulations would not apply for purposes of the rules covering retirement plans sponsored by state and local governmental entities under Section 414(d) of the Internal Revenue Code. But the definition of a political subdivision is relevant for many other purposes under the Code, such as exemptions from income taxes, payroll tax matters, special depreciation rules, the rules on charitable contributions and many other tax sensitive matters. It is not clear what effect, if any, the proposed regulations will have on the status of an entity as a political subdivision under these other provisions. Additionally, the definition of "political subdivision" for purposes of federal securities laws has also utilized the IRS definition by analogy. If narrowed as proposed, would that also affect the exemption from registration under federal securities laws for bonds issued by these governmental entities?

What About Bonds That are Already Outstanding?

The regulations are merely proposed at this point. If Treasury finalizes these regulations, the final regulations will apply to bonds issued more than 90 days after the effective date of the final regulations, which is the date that Treasury publishes the final regulations in the Federal Register. However, the final regulations will not apply to any current or advance refunding bonds issued after the effective date of the final regulations that are issued to refund bonds issued before the effective date, as long as the refunding bonds do not extend the remaining weighted average maturity of the refunded bonds.

What You Can Do

It is very important that the Treasury and IRS be made aware of the sweeping (perhaps unintended) effects the Proposed Regulations could have on a variety of traditional municipal issuers. You can comment on the proposed regulations, either by uploading documents or typing the comments in directly, on the federal government's regulations website. As noted earlier, comments are due by 11:59 p.m. EDT on May 23. If you want to speak at the IRS hearing in Washington DC on June 6, you must submit a request by May 23.

Lawyers in our Public & Infrastructure Finance Practice and Public Finance Tax group are available to discuss the implications of the proposed regulations, assist with the preparation of comments or discuss any other questions that you have.